

competition.<sup>34</sup> AT&T has responded with its own "One Rate" plan offering calls for a flat rate of \$0.15 a minute regardless of distance or time of day.

**5. Competitiveness of wholesale long distance services precludes market power.**

The competitiveness of long distance services is further enhanced by structural features of the market. Extensive excess capacity for bulk transport is available from multiple suppliers, which guarantees the existence of competitive wholesale markets.<sup>35</sup> The ability to purchase essential inputs in competitive wholesale markets eliminates an important source of potential entry barriers. That is, bulk transport services will be available at efficient, cost-based prices (*i.e.*, at prices that approximate the long-run, forward-looking incremental cost of providing long distance facilities). This outcome, in turn, implies that flexible reseller

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<sup>34</sup> *Ibid.*, page 65.

<sup>35</sup> The FCC has generally concluded that the market for business services is competitive. In 1991, the FCC found the outbound business services market segment to be "substantially competitive" based principally on its findings "that the business services marketplace is characterized by substantial demand and supply elasticities." (See Report and Order, *Competition in the Interstate Exchange Marketplace*, 6 FCC Rcd. 5880, 5887 (1991)). This finding was recently reaffirmed (see *In the Matter of the Motion of AT&T Corporation to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd. 3271, 3318 (1995)). The FCC made the same finding with respect to inbound (*i.e.*, 800) services in 1993, once 800 numbers were made portable (see Second Report and Order, *Competition in the Interexchange Marketplace*, 8 FCC Rcd. 3668 (1993)).

entry can quickly exploit and eliminate any arbitrage opportunities which may temporarily arise if retail prices rise above efficient, incremental-cost-based levels.

The competitiveness of bulk wholesale markets is one of the most potent structural guarantors of effective and aggressive competition for retail services. Moreover, the availability of bulk transport services in wholesale interLATA markets is not comparable to the volume-discounted services offered to high-usage customers in local exchange markets. In long distance, bulk transport may be used as an input to offer a wide array of retail long distance services; it is therefore more akin to the prospective market for unbundled network elements than to that for existing local services. While all of the inputs necessary to offer long distance service are presently available in competitive markets, the same cannot be said for local exchange services.

Furthermore, while the Interexchange Carriers (IXCs) actively attempt to differentiate their offerings in terms of discount structures (e.g., AT&T's True USA versus MCI's Friends and Family 2) and in terms of quality (e.g., AT&T's True Voice), the focus of retail competition remains on price. Some BOC experts have argued that these attempts favor price collusion rather than price competition.<sup>36</sup> They argue that IXC services are relatively homogeneous and that their costs are similar, and that via the

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<sup>36</sup> See Paul W. MacAvoy, note 30, *supra*.

tariff process, the IXCs coordinate their pricing decisions to avoid active competition. Putting aside both the fact that such collusion is against the law and that it is contrary to actual experience of long distance competition, arguments for collusion rest on a number of theoretical and factual errors.

First, the availability and use of complex discounting programs makes implicit price collusion extremely difficult because the carriers do not observe the acceptance rates for each other's discount programs. Such differentiation is even more extensive in the bulk wholesale services (e.g., long-term contracts and Tariff 12 offerings), which helps assure the competitiveness of retail toll services.

Second, while local exchange access costs do comprise a significant share of IXC costs (and reflect a subsidy to BOCs), there are many sources of cost heterogeneity reflecting technological differences and differences in marketing costs.<sup>37</sup> These differences are especially relevant for competition in the wholesale markets for bulk bandwidth where specialized facilities-based competition is prevalent.

Third, the pattern of similar pricing changes which has been erroneously dubbed "lock-step pricing" is consistent both with collusion (as the BOCs claim) and with competition (as all of the

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<sup>37</sup> See B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 2, page 49; and Declaration of R. Glenn Hubbard and William H. Lehr, note 18, *supra*.

other evidence suggests).<sup>38</sup> Furthermore, in a competitive environment, similar moves in the tariff for basic rate services can be explained easily as a rational marketing response necessitated by the need to avoid confusing consumers who are attempting to evaluate alternative discount programs. Consider the marketing problem of selling in the presence of a competitor who offers a larger discount (on which consumers are most likely to focus) from a generally higher basic tariff (which few consumers ever read). Because the principal competitive efforts of the IXC's are focused on differentiating their products via discount or enhanced-service offerings, these offerings ought to be the focus of an analysis of pricing behavior.<sup>39</sup>

Fourth, the alleged success of AT&T, MCI, and Sprint to collude on prices to earn excess margins would provide a potent inducement for expansion by existing competitors such as Worldcom, Excel, or Frontier, and would attract new entry into the market (for example, from out-of-region BOCs, CAPs, or cable television

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<sup>38</sup> For example, common cost shocks should elicit similar pricing responses under many market structures.

<sup>39</sup> As we noted earlier, this point explains why simplistic comparisons of tariff schedules should be avoided. A better measure of pricing trends is provided by comparing average revenue per minute trends, which reflect the weights of actual market demand, rather than arbitrary weights selected to support an advocacy analysis. Furthermore, higher basic rate service is likely to encourage accelerated migration to the new service offerings which is in keeping with the desire of IXC's to differentiate their products.

carriers).

To summarize, the structural features of long distance services encourage aggressive competition.

This competitive situation is quite different from that in local exchange markets. In local markets, almost all of the capacity is controlled by a single carrier. Today, with the BOC entry restriction into in-region, interLATA services in effect, the BOCs have an incentive to provide non-discriminatory access services to all long distance carriers. As we discuss further below, this incentive disappears once the BOC becomes a long distance competitor. The recent behavior of Southern New England Telephone Company (SNET) and GTE illustrates this phenomenon. AT&T has filed a complaint against SNET for its discriminatory behavior marketing its long distance services in Connecticut,<sup>40</sup> and GTE has been delaying interconnection negotiations with AT&T, severely hindering AT&T's ability to provide local service.<sup>41</sup>

**6. Customer switching among carriers demonstrates consumer sovereignty.**

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<sup>40</sup> See *Petition of AT&T Communications of New England, Inc. for Review of the Southern New England Telephone Company's Local Office and Other Practices*, filed September 9, 1996, Docket No. 96-09-05.

<sup>41</sup> See *Direct Testimony and Exhibits of Russell D. Morgan on Behalf of AT&T Communications of the Southwest, Inc. in connection with SOAH Docket No. 473-96-1191, PUC Docket No. 15711 (Complaint of AT&T Communications of the Southwest, Inc. Against GTE Southwest, Inc., et al.)*, page 28.

Potent evidence of consumer sovereignty is provided by the pace with which customers shift among long distance service providers. This provides a better measure of the level of competitiveness of a market than a simple comparison of overall market shares. For example, AT&T experienced 19 percent churn in 1992, and over 42 million long distance subscribers changed carriers in 1995.<sup>42</sup>

To summarize, available evidence points to the conclusion that competition in long distance services is quite vigorous.

**B. Competition in Local Exchange Markets**

**1. Lack of present competition in local services**

Consideration of similar data used to evaluate the competitiveness of long distance markets yields a starkly different conclusion: Markets for local exchange are not competitive presently. With the exception of a few niche markets, customers can purchase local exchange services from only one firm. The BOCs have a *de facto* monopoly that grants them significant market power over facilities that are essential for competition in both long distance and local telephone markets.

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<sup>42</sup> See B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 2, page 67. The 19 percent churn statistic is based on the share of AT&T revenue associated with customers who either left AT&T for another carrier or vice versa.

In Oklahoma, SWBT possesses more than a 99% share of the local exchange market. Brooks Fiber, in contrast, has fewer than 30 facilities-based customers, and its only residential customers are a handful of its own employees who are engaged in a test of resold service from SWBT.<sup>43</sup> The entire state of Oklahoma does not yet have a single unbundled loop being used for local service.<sup>44</sup> In addition, AT&T purchases all of its switched access in Oklahoma from SWBT.

In contrast to prices for long distance services, prices for local services have increased -- even after adjusting for the reduction in access charge revenues collected from the long distance providers (see Figure 6).<sup>45</sup> According to a recent study by the Consumer Federation of America, the ILECs are "earning \$4.5 billion annually in charges resulting from excess profits at the expense of captive telephone ratepayers."<sup>46</sup>

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<sup>43</sup> See Affidavit of Steven E. Turner.

<sup>44</sup> Id.

<sup>45</sup> The data in Figure 6 shows that the Producer Price Index (PPI) for local services has risen 43 percent while the PPI for MTS and WATS fell 23 percent and 32 percent, respectively, from 1983 until 1995. Moreover, this relative disparity is understated because the PPI inadequately accounts for discount programs which are much more important in long distance services than in local services.

<sup>46</sup> See "Study Finds \$4.5 Billion in Annual Excess Profits for Local Monopoly Telcos," Press Release from Consumer Federation of America, September 18, 1996, page 1. The press release summarizes results from a report by Mark N. Cooper, "Excess Profits and the  
(continued...)

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This study goes on to show that local phone rates have increased in recent years, despite the fact that the overall cost of providing service has been declining.<sup>47</sup> Monopoly profits support cost inefficiencies<sup>48</sup> and provide the RBOCs with a war chest from which to fund anticompetitive activities. To quote BellSouth:

"[T]he dominant incumbent, if it fails to accept the benefits which flow from a competitive market, can and will rationally use interconnection negotiations to delay and restrict the benefits of competition.....A dominant incumbent can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings. In addition, it can divert or delay

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<sup>46</sup> (...continued)

Impact of Competition on the Baby Bells," Prepared for the Consumer Federation of America, Washington, D.C., September 1996.

<sup>47</sup> The study concludes by stating: "The pressures put on regulators by the Baby Bells is certain to be vigorous, but the evidence is compelling that if regulators do the right thing, the initial impact of competition will be to restore Baby Bell profits to reasonable levels and create a level playing field for competition." See Mark N. Cooper, note 46, *supra*.

<sup>48</sup> According to BellSouth, "monopoly-bred inefficiency plays into the incumbent's hands by (1) enabling dramatic improvements in operating results through relatively easy 'fatcutting,' and (2) justifying high interconnection prices designed largely to recoup the incumbent's past inefficiencies" (see *Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalization of Telecommunications Infrastructure and Cable Television Networks*, BellSouth Europe, March 15, 1995, page 5).



competition and innovation to protect its current revenues...<sup>49</sup>

In recognition of their dominant position, BOCs such as SWBT are subject to substantial regulatory oversight from state commissions and the FCC. This ranges from traditional rate-of-return regulation in some states to more indirect forms of oversight in other states. The Telecommunications Act of 1996 anticipates the eventual deregulation of all telecommunications services, once effective competition makes regulatory oversight unnecessary.

CAPs such as Metropolitan Fiber Systems (MFS) and Teleport typically have aggressively competed for the particular services of a segment of customers in a subset of markets. These are principally the access services demanded by large commercial

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<sup>49</sup> See *Regulation of Access to Vertically-Integrated Natural Monopolies*, discussion paper, BellSouth New Zealand, September 1995, page 2. Later the same report argues that it is rational for the incumbent:

"to exploit the regulatory regime to the greatest possible extent without exposing itself to the threat of intervention or adverse changes to the regime. In fact, the directors of the dominant incumbent have a fiduciary duty to seek to extract the highest rents available to it as a result of its business position (as does any other profit-maximizing firm).....It has very powerful incentives to include monopoly rents in the price of complementary network services in order to perpetuate and increase its monopoly profits. It similarly has powerful incentives to reduce the ability of its competitors to claim market share." (page 10)

customers in major metropolitan areas, and most often located in large office buildings. Therefore the CAPs are irrelevant to the vast majority of customers in most markets, most particularly residential customers.<sup>50</sup>

Even if the CAPs' market focus were broader, their physical capacity is both too small and too limited in geographic coverage to handle more than a small subset of BOC traffic.<sup>51</sup> Accordingly, the presence of CAPs in certain areas does not constrain BOC monopoly power or the BOC's ability to engage in leveraging.

The opening of local exchange markets to effective competition as anticipated by the Act will encourage innovation and the further development of local exchange technologies. Two areas appear promising. First, telephony services may be added to existing non-telephone wireline networks (*i.e.*, cable television or

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<sup>50</sup> The CAPs' principal market opportunity has been to provide special access (*i.e.*, dedicated access) and private line services in many cases to long distance carriers to interconnect their points of presence (POP) and the BOCs' switching centers. This has been feasible because these are the services which depend least on cooperation of the BOCs and rely least on the BOCs' facilities. Therefore, CAPs are less vulnerable to anticompetitive practices by the BOC.

<sup>51</sup> According to B. Douglas Bernheim and Robert D. Willig (note 18, *supra*, Chapter 3, page 10), the CAPs deployed 700,000 network fiber miles of transmission capacity in 1995, compared to the LECs' more than 8 million fiber miles and well over a billion miles of copper cable. In 1995, there were only 9,000 buildings on CAP networks nationwide (see B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 3, page 11).

electric utility networks). Second, there are a number of wireless technologies such as PCS which may provide an alternative technology platform for offering local exchange services. While both may provide promising avenues from which future competition may emerge, they remain commercially unproved technologies at this point. Therefore, we cannot rely on these technologies to restrain BOC market power today.

Overlaying telephony services on an existing cable television or electric power network presents a number of important challenges. First, there is no generally available technology for providing telephony over cable or electric networks. Second, there has been no history of direct telephony experience. Third, there are significant costs associated with retrofitting these networks to support telephony. There is no general agreement among analysts about the optimal strategies and costs for effecting these upgrades. Fourth, in the case of cable television, many carriers have a poor reputation for service quality which would need to be remedied before these firms would be credible as viable telephony competitors. Fifth, as the dominant providers of local television entertainment services, cable television providers may have an incentive to adopt a strategy of mutual forbearance wherein they stay out of telephony with the implicit understanding that the BOCs stay out of television services.

Wireless technologies may offer more future potential, but they raise a significant number of technical issues. The chief

selling point to date for wireless services has been mobility. Such service is a *complement*, not a *substitute*, for fixed wireline local telephone service. Wireless service commands significantly higher prices as a premium service, despite the generally inferior quality of wireless telephone relative to wireline service. Furthermore, important technical disagreements over what standards to use (e.g., CDMA or TDMA) need to be resolved.

**2. Sources of difficulty introducing local exchange competition**

To compete in local exchange services, an entrant must rely on the cooperation of the monopolist BOC -- in this case, SWBT. At the very least, an entrant will need to interconnect to the BOC's facilities in order to exchange traffic between callers on the entrant's network and the BOC's. Moreover, as recognized by the Act, it is neither feasible nor efficient for an entrant to replicate all of the facilities of the BOC in order to provide service. Therefore the BOC is required by the Act to offer for sale both UNEs and wholesale versions of its retail services. For entry to be feasible, an entrant needs to be able to lease essential monopoly inputs on a flexible basis from the BOC. If these inputs are priced at efficient levels, then the entrant will be able to make the correct "make versus buy" decisions and will invest in facilities only when such investment is efficient.

Obviously, an entrant that is willing to focus narrowly on special access or private line services is less dependent on the

cooperation of the BOC, and hence less vulnerable to anticompetitive behavior. Broad entry into local exchange services of the sort anticipated by AT&T requires entry into switched services and thereby depends on the full cooperation of the BOC. A BOC is unlikely to cooperate willingly because competition threatens its dominant market position. It would prefer to maintain its monopoly over local services and be granted opportunities to expand into other services without having to face any regulatory constraints. This preference is simply consistent with profit-maximizing behavior. The Act and the FCC's Order clearly recognized the necessity of a legal mandate if a BOC such as SWBT is to cooperate with entrants.<sup>52</sup> Indeed, if such legal mandates were unnecessary, the Act would have been unnecessary.

There are many price and nonprice strategies which a BOC can utilize to directly or indirectly hinder the emergence of effective competition. The price strategies are only the most obvious: If the prices charged for essential inputs are above

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<sup>52</sup> The FCC's Order notes that "[a]n incumbent LEC ... has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions" (see paragraph 10 of the *First Report and Order*, In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Released August 8, 1996, hereafter referred to as *First Report and Order*). Moreover, the FCC recognized that the BOCs possess superior bargaining power and that a new entrant "comes to the table with little or nothing the incumbent LEC needs or wants" (see *First Report and Order* ¶ 15).

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efficient levels, then entry will be deterred. The BOC has an incentive to misrepresent cost data and to misallocate costs in order to induce regulators to set prices for UNEs, interconnection and wholesale services which are too high. The BOC has an incentive to seek to restrict the range of services and UNEs which entrants may purchase and to argue for inefficient surcharges (e.g., to subsidize its carrier-of-last-resort obligations or to recover historical costs) in order to force prices above efficient levels.

In addition to the pricing strategies suggested above, the BOCs can avail themselves of a wide range of nonprice strategies which are often more difficult to detect and deter. Entry into local exchange services is difficult because it requires a huge investment and depends on cooperation from a hostile competitor. While the Act provides the public policy framework for addressing these issues (in the Section 251 requirements), implementation of these rules will be difficult.

Economists have identified several price and nonprice strategies which may be employed by a monopolist such as a BOC to exploit, extend, and protect its market power. First, a monopolist can exploit its market power by setting high prices, generally well above costs. Moreover, a monopolist chooses the range of products to offer based on what maximizes profits for the monopolist, not what consumers most want. In some cases, this results in poor quality (because consumers have no choice but to accept what the

monopolist offers) or in other cases, excessive investments in features which appeal to only a subset of customers but for which the monopolist can force all customers to pay (e.g., investments in broadband services). Traditionally, regulators have attempted to control these activities by setting quality standards, by determining what capital investments are allowed into rate base, and by setting prices for retail services -- and by restricting the monopolist's participation in competitive markets (e.g., long distance services) to protect those markets and to limit the monopolist's ability to circumvent regulatory controls. However, such control is imperfect because the monopolist BOC possesses superior information regarding the actual nature of its costs and consumer demand.

Second, a monopolist may seek to extend its market power by "monopoly leveraging." That is, a monopolist in one market may seek to extend its power to another related market, which is most easily accomplished when the monopolist controls an essential input in the second market. By tying or bundling the purchase of the goods in the two markets, the monopolist can extend its power over both markets. For this reason, the courts have often acted as if there is a *per se* restriction against tying where the firm has market power, in spite of the fact that more recent economic theory suggests that there can be efficiency-based motivations for tying and that the circumstances under which this is the preferred mechanism for extending monopoly power are limited. However, tying

is likely to be attractive as a mechanism for avoiding rate regulation (e.g., if the essential input is subject to a price ceiling that limits the BOC's ability to extract profits from its sale).

Third, and perhaps most likely, a monopolist is likely to seek to protect its market position by "raising its rivals' costs," a generic expression for a whole class of price and non-price predation and foreclosure strategies.<sup>53</sup> The BOC can potentially raise an entrant's costs by manipulating any of the price or non-price terms associated with the essential inputs which the entrant requires to effectively compete in the market (e.g., interconnection services, UNEs or wholesale versions of retail services). In addition, SWBT can provide inferior-quality service unless regulators are vigilant and contracts regarding

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<sup>53</sup> An upstream monopolist (i.e., the BOC which controls local exchange access) generally will have an incentive to discriminate against downstream rivals (i.e., interLATA competitors) as explained in recent papers by Nicholas Economides (see Nicholas Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist," Mimeograph, Stern School of Business, New York University, January 1997) and by Randolph Beard, David Kaserman and John Mayo (see Randolph Beard, David Kaserman and John Mayo, "Regulation, Vertical Integration and Sabotage," Mimeograph, University of Tennessee, January 1997). The findings of these stand in contrast to the result proposed in a recent working paper by David Sibley and Dennis Weisman (see David Sibley and Dennis Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers," Mimeograph, University of Texas, Austin, November 1995). Sibley and Weisman err by assuming that the downstream (interLATA) subsidiary of the BOC maximizes its own profits and fails to take account of the consequences of its decisions for the profits of the integrated company. Such an assumption is inconsistent with rational value maximization.



interconnection, UNEs, and wholesale services are suitably specific in their requirements.

Alternatively, a BOC may seek to create "customer switching costs" in order to make it more difficult for an entrant to attract new customers -- for example, anything which damages the reputation of the new entrant (e.g., poor-quality service due to slow delivery, maintenance or repair, or noisy local loop facilities), makes it difficult for a customer to learn about new entrants (e.g., misleading advertising by the BOC), or makes it difficult for a customer who wishes to change suppliers to actually do so (e.g., cumbersome procedures for effecting the transfer of customers to a new local service provider).

### **3. Indirect strategies for frustrating competition**

These are just some of the more obvious direct strategies which may be employed to hinder progress towards effective competition which regulators will need to protect against.<sup>54</sup> There are also many indirect strategies which can be as effective in slowing the emergence of local exchange competition. These indirect strategies are even harder to detect and hence even more difficult to deter.

The emergence of local competition is likely to encourage

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<sup>54</sup> See also the more extensive discussion in B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 4.

the development of new and innovative products and services which will further complicate what is already a very complex marketplace. The BOC will likely engage in a wider array of markets of varying degrees of competitiveness and subject to varying degrees of regulatory oversight. Therefore, preventing cross-subsidization and other attempts to circumvent regulations by actions taken in unregulated markets will become more difficult.

Moreover, the possibility, on occasion, of an "efficiency" rationale for strategies that have anticompetitive consequences provides the BOC with ample opportunities to deny plausibly that a particular strategy is being employed for anticompetitive purposes. Moreover, in the face of rapid technological progress, it may be impossible to reverse the damage caused by the strategy if regulators wait until the damage becomes evident. Even if the BOC were enjoined from using the anticompetitive strategy in the future, new such strategies can be used, and the BOC has the first-mover advantage of being able to decide when and how to move.

Four classes of examples illustrate some of the strategies. First, because an entrant requires the BOC's cooperation in order to arrange interconnection, purchase UNEs, and resell wholesale services, the BOC can devote insufficient resources to the task of sustaining this cooperation. The promotion of competition will require active cooperation by the BOC; its neglect or slow response time, therefore, can be quite

effective at thwarting competition.

There is already substantial evidence that SWBT has engaged in such dilatory tactics in its negotiations with potential entrants. When AT&T opened UNE negotiations with SWBT, the BOC contended that the 1996 Act's unbundling requirements applied to only four network elements, and it slowed negotiations until the FCC issued its *First Report and Order*, 145 days after AT&T made its initial interconnection request. Then, after the FCC made clear that at least eight UNEs must be provided on a non-discriminatory basis, SWBT further delayed discussion of UNE OSS details until October 16, 1996.<sup>55</sup> SWBT has also impeded collocation by delaying requests and quoting exorbitant prices. In Texas, AT&T waited months for SWBT to offer a 400 square foot collocation cage, with proposed average non-recurring charges of \$550,000 per office.<sup>56</sup> Brooks Fiber has similarly complained to the Kansas Corporation Commission that SWBT's "collocation prices are excessive and that the time frames required by SWBT to process Brooks' collocation applications have been unreasonably long."<sup>57</sup>

Second, the BOC may exploit its ability to discriminate selectively. Because the BOC controls the timing, design, and scope of its facility upgrades and the services it offers, it can

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<sup>55</sup> Affidavit of Rian J. Wren.

<sup>56</sup> Affidavit of Steven E. Turner.

<sup>57</sup> Brooks Communications of Missouri, Inc. response to KCC Staff Data Requests, Docket No. 97-SWBT-411-GIT, Question J.

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manipulate these activities strategically to affect rivals differentially. It will be quite difficult to prove that a BOC delayed implementation of a feature required by an entrant because it wished to harm the entrant as opposed to its technical or other inability to respond sooner. Alternatively, a BOC can choose the level of quality which it offers to all entrants in such a way as to harm particular entrants selectively. For example, the BOC may argue that it is implementing a minimal functionality, "lowest common denominator" systems interface in order to avoid discriminating against limited-capability entrants when the real motivation is to deny access to increased functionality to more threatening competitors.

Third, seemingly "nondiscriminatory" quality degradation can be discriminatory in the following important sense: Entrants to local exchange services must establish a reputation for quality in order to attract customers, and a reduction in overall quality that coincides with the onset of competition would increase the difficulty of acquiring such a reputation. Similarly, local service quality problems which can be assigned to the onset of competition will mislead consumers regarding the benefits of competition and may make it more difficult for state commissions to implement the requirements of the Act. Finally, a reduction in quality could damage the investments of long distance carriers in their reputations for quality service, narrowing any consumer perceptions that long distance carriers offer better service than

the BOC.

Fourth, while the Act requires the BOC to cooperate, the Act is quite complicated and its provisions and requirements are unlikely to be fully understood by the ILEC's employees. An ILEC does not need to tell its employees to be uncooperative or to try to mislead customers about the likely impact of competition. Indeed, many of the employees may decide to behave in this way on their own. The BOC's employees are likely to associate the onset of competition with increased job insecurity and the language of healthy business competition often characterizes competitors as "the enemy." Therefore, by failing to devote adequate resources to supervising or educating employees of their obligations under the Act, FCC regulations and arbitrated decisions, a BOC may be able to implement a decentralized, anticompetitive strategy or have it implemented on its behalf by its employees. This is especially difficult to protect against because it does not require centralized coordination; there does not need to be a smoking gun.

Whether the ILEC uses neglect, fails to supervise workers adequately, strategically chooses "nondiscriminatory" service standards so as to harm competitors, allows overall quality to degrade, mobilizes opposition to competition, or other anticompetitive strategies, the effect will be the same: *Progress toward effective competition will be slowed.*

There is ample evidence that the BOCs have both the incentive and ability to hamper competition for local exchange

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service.<sup>58</sup> For example, SWBT attempted to charge Teleport \$400,000 for a 10' X 10' wire center space, similar to ones leased to long distance companies for about \$15,000.<sup>59</sup> In 1994, in violation of FCC orders, SWBT filed virtual collocation tariffs lacking rates for interconnector-specified equipment and related cost support data.<sup>60</sup> Presently, Brooks Fiber is engaged in an on-going struggle to extract from SWBT equipment and information necessary to obtain and serve new customers.<sup>61</sup>

SWBT is not the only RBOC that has resisted attempts to open up local exchange markets to competition. Teleport alleges that NYNEX has forced it to construct "an extremely expensive and technically inefficient dual-trunking network to accommodate meet-point billing arrangements."<sup>62</sup> Teleport also claims that NYNEX refused to order and deliver the trunking arrangements required to

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<sup>58</sup> See the general discussion in *Affidavit of Michael Starkey on Behalf of AT&T Communications of Michigan, Inc.*, In the Matter of the Commission's Own Motion To Consider Ameritech Michigan's Compliance with the Competitive Checklist in Section 271 of the Telecommunications Act of 1996, Before the Michigan Public Service Commission, Case No. U-11104.

<sup>59</sup> O'Reilly, "First Blood in the Telecom Wars," *Fortune Magazine*, Vol. 133 No. 4 (March 4, 1996).

<sup>60</sup> In re Southwestern Bell Tel. Co., 9 FCC Rcd 6488 (1994).

<sup>61</sup> See The Dallas Morning News, "SBC Petitions To Sell Long Distance; FCC Considers Baby Bell's Request To Enter Oklahoma Market," *Business 1F* (April 12, 1997).

<sup>62</sup> "TCG Says SWBT-New York Stifles Interconnection," *Telecommunications Reports*, October 23, 1995, vol. 61, no. 42.

originate intraLATA 800 calls, refused to issue NXX codes, and failed to propose, implement, or develop various necessary billing arrangements.<sup>63</sup>

Other RBOCs have engaged in various attempts to frustrate the entry of competitors into local exchange markets. Since April 1994, US Signal's efforts to offer local exchange services in Michigan have been hampered by Ameritech's failure to provide necessary facilities, as required by regulations.<sup>64</sup> Representatives of the Michigan Public Service Commission concluded that "Ameritech tried to set exorbitant prices, dictate how rivals must set up their to networks, and impose charges the state doesn't allow..."<sup>65</sup>

US Signal is not the only competitor to encounter difficulties with Ameritech. In 1994, MFS filed a complaint alleging that Ameritech was not compensating it for terminating local and long distance traffic, and "deliberately obstructing" its ability to function with the "full benefits of a LEC" in

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<sup>63</sup> *Ibid.*

<sup>64</sup> See B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 4, page 84.

<sup>65</sup> See B. Douglas Bernheim and Robert D. Willig, note 18, *supra*, Chapter 4 page 85.

Illinois.<sup>66</sup> The Illinois Commerce Commission eventually upheld this complaint, concluding that Ameritech had unlawfully discriminated against MFS.<sup>67</sup>

US West's conduct has also inspired a variety of complaints. ICG Access Services, Inc. has alleged that the RBOC repeatedly delayed filling orders for transmission facilities needed to provide competitive access services.<sup>68</sup> LCI has asked the Justice Department to investigate US West for anticompetitive practices aimed at obstructing LCI's expansion into US West's local markets. According to *The Wall Street Journal*:

LCI said the Baby Bell turned off some services for 4,000 LCI customers in the Denver area that resulted in a 24% cancellation rate within 90 days of the outage and 'pulled the rug out' from under LCI's marketing efforts in Denver and Phoenix by promising and then failing to meet installation of new services. US West employees compounded LCI's problems, the complaint says, by 'wrongly' advising LCI customers who

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<sup>66</sup> *Communications Daily*, December 8, 1994, page 10.

<sup>67</sup> Leslie Cauley, "Bell Atlantic Seeks Court Blessing in Bid to Quiet Critic of MFS," *The Wall Street Journal*, February 9, 1995, page B6.

<sup>68</sup> See *Telecommunications Reports*, May 1, 1995.



called to complain that LCI had gone out of business.<sup>69</sup>

BellSouth has also engaged in anticompetitive activities. In South Carolina, following the opening of the intraLATA toll market to competition, BellSouth introduced its Area Plus discount calling plan which offered a rate of \$0.11 per minute for calls during the day and \$0.055 per minute for calls in the evening. Competing IXC's which were paying BellSouth \$0.12 per minute for access were confronted with a vertical price squeeze. Furthermore, BellSouth sought to discriminate against potential entrants into the intraLATA market by agreeing to terminate the traffic of other ILECs in the state at reduced access rates.

While these examples illustrate the range of discriminatory and anticompetitive strategies which may be employed by an ILEC to deter the emergence of effective competition, it is important to remember that because it is difficult to detect such behavior, only a small subset of anticompetitive activities are likely to be observed in the trade press and regulatory proceedings.

#### **IV. CONSEQUENCES OF BOC ENTRY INTO LONG DISTANCE SERVICES**

As we noted at the outset, we do not recommend the approval of BOC applications such as SWBT's to compete in interLATA

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<sup>69</sup> See "LCI Wants Justice to Probe US WEST Practices," *The Wall Street Journal*, October 11, 1995, page B7.